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TREASURY DEPUTY SECRETARY STUART EIZENSTAT TESTIMONY BEFORE THE SENATE COMMITTEE ON COMMERCE, SCIENCE, AND TRANSPORTATION

C Introduction

Mr. Chairman, Senator Hollings, Members of the Committee. Thank you for providing me the opportunity to discuss with you the important issue of natural disaster insurance. Let me begin by complimenting you, Senator Stevens, for your steady and consistent leadership on this issue. We look forward to continuing to work with you toward our shared objective of achieving a legislative outcome commensurate with the seriousness of the problem.

Disasters are of grave importance for all. Their cost can be astronomical, not only in financial terms but also in human terms. The Administration, under the leadership of James Lee Witt, the Director of FEMA, has developed a comprehensive policy for dealing with natural disasters, going beyond simply the response to them, to work with local communities to reduce their exposure to natural disasters. We view well-functioning insurance markets as a complement to that policy. While insurance cannot undo the costs of a natural disaster in human terms, it can provide the foundation for a sound recovery in financial terms.

We believe there is a role for the Federal government to play with respect to the provision of reinsurance for the risk associated with the most severe, least probable disasters. We believe that role should respect two principles – that we should leave more than enough room for private market activity to grow and flourish, and that the taxpayers should be adequately compensated for any financial risks they are asked to bear. In line with those principles, we believe the Federal involvement should be strictly limited, and on an interim basis, pending the more complete development of private market solutions.

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In that regard, we see the legislation now before the Committee as a generally positive step forward. In our view, the proposed legislation constructively and creatively responds to the difficulty faced by both state funds and private entities in purchasing reinsurance against their potentially large, but low-probability losses on homeowners= insurance. Although we are concerned about some aspects of the bill, I understand that our respective staffs have begun a productive dialogue, and we look forward to working with Members on both sides of the aisle to explore means of resolving those concerns.

An important portion of the bill addresses issues related to mitigation. We respect and appreciate your interest in this topic. As you know, the Administration strongly supports efforts to encourage mitigation, an indispensable form of "preventive medicine" to protect communities against the ravages of natural disasters, and is placing increased emphasis on *pre*-disaster mitigation efforts. However, this vital area is not a province of Treasury, so I must defer to FEMA on questions that reach solely to mitigation policy and provisions. My testimony will therefore focus on the reinsurance aspects of the bill, and will touch on mitigation provisions only insofar as they affect those reinsurance aspects. However, let me say that we view insurance markets and pre-disaster mitigation initiatives as natural complements, and I understand, Senator Stevens, that you have spoken with Director Witt several times on mitigation.

II. Review of the Problem and Our Principles

The characteristics of natural disasters make the risk associated with them especially difficult for insurers to handle: natural disasters happen only infrequently, but when they do occur, they can be exceedingly severe. Reflecting this difficulty, prices for disaster reinsurance for homeowner losses can be very high measured relative to expected losses, and prices have in the past spiked -- and markets shrunk -- for a considerable time following a disaster.

Because of their tremendous capacity for absorbing losses, we view the capital markets, in which disaster risk increasingly can be bought and sold like many other risks, as a crucial complement to the traditional reinsurance industry. We have closely monitored the development of capital markets. While progress has not come as fast as we had hoped, we still expect that insurance securitizations in capital markets will be a significant part of well-functioning markets for disaster risk in the long run. But we are persuaded that a problem still remains at least for a time -- while the volume of these securitizations builds -- and that a well-designed transitional Federal program could be constructive.

Four considerations argue in favor of a prudent, interim participation of the Federal government in the market for disaster risk management at this time. First, it is better to consider undertaking policy prior to a catastrophic event; surely, if we can do it, the time to fix the roof is when the sun is shining. Second, the Federal government is uniquely capable of spreading risk across the population and over time. The capacity of the Federal government to gather resources from a wide base for the purpose of meeting short-term contingencies dwarfs that of any single private-sector entity. Third, the Federal government would likely bear part of the cost associated with stabilizing distressed insurance markets in a truly cataclysmic event regardless of whether legislation of the type now before the Committee is enacted. Finally, prudent participation at this stage of development may enhance the ability of private markets to deal with these risks.

It is essential that any Federal involvement be guided by a set of common-sense principles. Let me enumerate those principles.

C Federal involvement *must support, not supplant*, private insurance markets.

-- It must be *partial*, applying only to true catastrophes that the private market is not capable of handling.

-- It must be *transitional*, phasing down as private markets develop.

C Federal involvement *must share, not subsidize,* risk.

-- Federal involvement *must create new capacity* to absorb risk, but that involvement should be priced so as to compensate the taxpayer adequately for the financial risk involved. In particular, the pricing of this Federal involvement should be sufficiently robust to ensure that – on a prospective, probability-weighted basis – the program will impose *no net cost* on the taxpayer.

C The Bill Before the Committee

Let me now turn to the specifics of the proposed legislation before you. In brief, S. 1361 would establish a new not-for-profit Corporation that would sell excess-of-loss reinsurance to qualifying state funds, and auction industry excess-of-loss contracts to interested State or private purchasers for losses above certain threshold "deductible" amounts, incurred on residential policies. The Corporation would establish a Trust Account into which a portion of contract payments and associated investment earnings would be placed; and would disburse monies from that Trust as well as proceeds from its own borrowings, if any, to holders of its contracts in the event of a qualifying disaster. The Corporation would be able to borrow from private markets; in addition, it would be eligible to borrow from the Treasury in the event that its other resources proved insufficient to make promised payments. The bill would establish an Independent Board of Actuaries that would approve the initial operating plan, and help ensure that the pricing of the contracts sold by the Corporation offered sufficient protection for taxpayers.

The bill would require that states develop and undertake mitigation plans approved by FEMA to reduce the hazards of covered disasters, with progress to be evaluated periodically by FEMA. It would also establish in Treasury a separate Mitigation Account, consisting of required annual payments by the Corporation and appropriated funds, to be distributed to participating state programs that have satisfied the mitigation plan requirement.

IV. Suggested Improvements

We believe there are several ways in which the legislation can be improved so that it better addresses the market problem as we see it and fulfills our public stewardship responsibility. Let me enumerate here the most important of these suggested improvements.

<u>Governance</u>

S. 1361 would establish a new Corporation, owned and operated by the purchasers of the disaster-related contracts sold under this program. This Corporation would have special ties to the government, including importantly a limited ability to borrow from the Treasury. Our concern with this aspect of the bill is that it would create an entity that is charged with fulfilling a public mission, making public judgments, and having access to public benefits, but that would be owned and controlled by purchasers. There is a risk that the entity may not carry out its charge appropriately, and could use its public benefits for its own private gain. In our view, a preferable approach would be to lodge the authority for this program squarely within the Federal government, for several reasons. First it would provide the very strong controls over operations that must be in place to assure that taxpayers are adequately protected in assuming risks such as these. Second, a Federal entity is better suited for making decisions of a truly public nature, such as are inherent in the operation of this program. To take just one example, pricing decisions must reflect considerations of fairness to taxpayers. Finally a

Federal entity could be focused narrowly upon the direct mission, and would be more easily sunsetted when there was no longer a need for Federal intervention. The House bill, H.R. 21, embodies a concept along the lines we prefer. We have had productive discussions with your staff on this topic, and would be pleased to continue to work with the Committee to develop alternatives that set the entity within the Federal government.

Cap

The proposed legislation would limit or "cap" payouts on the contracts sold by the Corporation in the event that contractual obligations exceed the resources of the Corporation. This cap would be implemented by limiting the Corporation's borrowing from the Treasury to the amount the Corporation could repay within 20 years. If contractual obligations were to exceed the sum of all resources available to the Corporation, available resources would be prorated among entities holding the contracts and due a payment.

We share your objective of developing a fiscally prudent piece of legislation. And we share your belief that a limit on the potential draw on the Treasury is an essential component of fiscal prudence. But we are concerned about the robustness of a cap that would, in some circumstances, require proration of payments across claimants. In those circumstances, we believe there would be enormous pressure for full payment to be made on all contracts despite the fact that the fees or premiums on the contracts had been set under the assumption that only partial payment might be made. As a result, we believe it plausible that taxpayers would be exposed financial risk for which they had not been fairly compensated.

We believe that it is possible to design an approach to capping the Federal liability that would avoid such exposure. One possible approach would involve limiting the amount of insurance to be sold. Briefly, a mechanism along these lines could work as follows. Contracts sold under the legislation would cover 50 percent of any losses above the deductible, up to an upper limit corresponding to the dollar amount that would be lost in an event of some more remote probability. For the sake of illustration, one could consider setting the upper limit at the dollar amount corresponding to a one-in-500-year event. Under this approach, the maximum theoretical draw on the Treasury could be calculated as the sum of the maximum obligations in each state and region. The probability that this draw would actually be made would be extremely small. The attached chart illustrates our proposal.

Thus, *under the approach we are proposing, the Corporation would sell only a limited amount of coverage, but, having sold it, would make good on all of it*. We have had constructive discussions with your staff on this point, and we would be happy to continue to work with the Committee to create a cap on Federal liability consistent with our mutual objective of designing a fiscally prudent program. The appendix explains our proposal in more detail.

Sunset

We believe that this program should be sunsetted after some fixed number of years. A sunset-type provision is important in order to preserve adequate incentive for the further development of the private market. As we have said earlier, we continue to believe that private markets will ultimately be able to supply coverage for even huge natural disasters, given sufficient opportunity for growth. The goal should be to ensure that the proposed program supports rather than supplants this growth of the private market. Again we would be happy to continue our work with your staff on this issue.

Continued Purchase Requirement

The proposed legislation would require a state program participant to continue purchasing reinsurance in the event that the participant were to receive a payout from the Corporation that caused the Corporation to borrow or to increase its borrowing from the Treasury. The participant must continue to purchase the reinsurance until the borrowed funds are repaid.

This provision raises some difficult issues. For one, it could further burden an already stressed entity (public or private) in the aftermath of an event, raising the possibility of a scenario, not unlike the one that causes us concern over the annual cap, in which the requirement would be waived. In this case the Corporation would have been inadequately compensated for the financial service it would have, in fact, provided.

While this provision may serve a useful role within the Corporation governance structure, it would not be needed were the program to be lodged within a Federal agency and were the cap on Federal liability to be revised as we have suggested. An alternative approach that might meet the intention of this provision would be to provide for the option of offering multiple-year, as well as one-year, contracts, if market conditions indicate that such contracts would be appropriate and desirable. We have had useful discussions with your staff on this issue also, and would be pleased to continue to work with your staff.

V. Conclusion

The Clinton Administration has long recognized the importance of improving the nation's ability to deal with natural disasters. While our list of concerns may seem long, it does not imply any lack of interest in working with you, and all of our suggestions derive from our two core principles: that relief for insured homeowners not come at the expense of taxpayers, and that any Federal intervention must share risk and support private markets. We believe that we all share a clear recognition of the importance of moving forward. The current proposed legislation provides a sound foundation for progress in this area, and we look forward to working with you, Mr. Chairman, the other Members of this Committee, its staff, representatives of industry and of affected communities, and with other stakeholders, to resolve these issues.

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Appendix

State Program Mitigation Requirement

With regard to the requirement that state programs commit a specified percentage of their investment earnings toward mitigation, we would suggest a wording change, to require that the mitigation activities undertaken by states to fulfill this provision be cost-effective, and consistent with general FEMA guidelines.

Tax Consequences of Buying Excess of Loss Contracts

The statute refers to the auctioned excess of loss contracts as "reinsurance coverage," and refers to the amounts paid by such contracts as "premiums." We should note that, as a technical matter, if an insurance company purchases an excess of loss contract where the amount payable does not indemnify the insurance company specifically for its actual losses, then the excess of loss contract would not be considered "reinsurance" for Federal income tax purposes. This, for example, will mean that insurance companies could not deduct amounts paid for excess-of-loss contracts as reinsurance premiums. Instead, insurance companies would have to account for these purchases using Federal income tax rules that apply to purchases of similar financial instruments. To avoid any potential confusion on this issue, we would recommend that the statute be revised so that excess-of-loss contracts are not referred to as reinsurance coverage.

Capping Payouts

After careful study, we have concluded that capping payouts is an imperfect mechanism for limiting the potential draw on the Treasury. We believe that an effective mechanism for limiting the total Federal liability and ensuring fiscal prudence is an essential feature of fiscally prudent legislation, and we are confident that such a mechanism can be devised. This section of the appendix provides additional detail relative to the discussion in the body of the testimony.

One approach we have been exploring would involve capping the amount of insurance to be sold by the Corporation. Under this approach, the *total* amount of insurance offered to each state and region would equal 50 percent of the difference between (a) a threshold trigger level (essentially, a “deductible”), and (b) an upper limit loss. The bill sets the threshold trigger level at the greater of (a) the amount that would be lost in a 1-in-100-year event, or (b) $2 billion (or, for existing state programs, the claims paying capacity of the program). The bill also provides for certain transition trigger levels. The upper limit loss could be set similarly at the amount that would be lost in some less probable event, such as a 1-in-500-year event.

- For example, if the 1-in-100-year loss on insured residential property in Missouri were $4 billion, and the 1-in-500-year loss were $8 billion, then the total amount of coverage offered to Missouri would be half of the difference between $8 billion and $4 billion, or $2 billion.

Coverage would be allocated between the state programs and the regional auctions in proportion to the share of the industry risk in each state that the state program (if any) covers.

State with 100 percent state program: If a state elects to create a state program that, as a matter of policy, reinsures every insurance entity with exposure to residential property losses in the state for all its losses above the deductible, we propose to offer the full state allocation to the state program. Because the full amount of coverage for the state had been offered to the state program, nothing attributable to this state would be offered in a regional auction.

No state program: If a state elects not to create a state program, we would attribute the full amount of that state's allocation to the applicable regional auction. If Missouri chose not to establish a state program, we would add $2 billion in total insurance to the auction of contracts for the region covering Missouri.

The cap or aggregate maximum payout would then be defined as the sum of the maximum obligations in each state and region, and funds would be made available up to the amount of this payout. The probability of hitting this cap would be extraordinarily small; the cap would be hit only if every state and region bought its full allotment of contract protection, and huge events happened to every state and region in one year and caused the maximum payouts in each state and region to be made.

An ancillary benefit of the approach sketched here is that it provides a natural method of allocating coverage across states and regions. The legislation as currently drafted does not address that issue.